No. 6586

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

D. W. JOHNSTON, as Trustee in Bankruptcy of the Estate of Dupont Milling & Sales Corporation, Bankrupt,

Appellant,

vs.

JOHN P. MCLAUGHLIN, Collector of Internal Revenue,

Appellee.

BRIEF FOR APPELLANT.

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BRIEF FOR APPELLANT.

This cause, at issue upon complaint and answer (Tr. 2-6), was submitted upon agreed statements of fact. (Tr. 17-20.) Judgment was for defendant and plaintiff appeals.

The error relied on is that the judgment is contrary to the law and the facts. Under the law, upon the agreed facts, judgment should have been for plaintiff.

STATEMENT OF FACTS.

DuPont Milling and Sales Corporation, now a bankrupt, had no taxable income for the year 1927. It

suffered a loss in that year. The president of the corporation, for the purpose of deceiving and defrauding its directors, stockholders and creditors, so kept the books of the corporation that they falsely indicated a profit. For the same fraudulent purpose the president made, on behalf of the corporation, a false income tax return showing taxable income that did not exist. (Tr. 22-31.) Because of this false return, money of the corporation was paid by the corporation to the defendant as an income tax, the defendant being the Collector of Internal Revenue for the district. Subsequently an agreement as to final determination of tax liability was entered into between the Commissioner of Internal Revenue and the corporation, the signature of the corporation being affixed by an officer other than the president who made the false return. (Tr. 31.) The corporation has since been adjudicated a bankrupt. Plaintiff is trustee of its estate. Creditors of the corporation, who were such at the time of the wrongful payment, are now creditors of the bankrupt estate. There are not sufficient assets in the bankrupt estate to pay claims of the creditors.

ARGUMENT AND AUTHORITIES.

In brief, the stipulated and admitted facts present a case in which an officer of a corporation, and as such a trustee for the corporation, fraudulently paid money of the corporation to one to whom the money was not due, and who parted with no consideration therefor, and this to the detriment of the then and now existing

creditors. The case is therefore controlled by the following elementary rules of law:

1. **Officers of corporations are trustees of its property.** 14 C. J. 99.

2. **It is the duty of a trustee to hold and apply the corpus of the trust to and for trust purposes only.** C. C. 2229.

3. **A violation of that duty is a fraud against the beneficiary of the trust, that is, the corporation.** C. C. 2234.

4. **One to whom property is transferred in violation of a trust holds the same as an involuntary trustee under such trust, unless he purchased in good faith and for a valuable consideration.** C. C. 2243.

5. **Property obtained by one through the fraudulent practices of a third person will be held under a constructive trust for the person defrauded, though the person receiving the property be innocent of collusion.** *Perry on Trusts,* 7th Ed., Sec. 211.

6. **Money received by a third person through the fraud of another may be recovered by the person defrauded in an action for money had and received against the third person.** *Clifford Banking Co. v. Donovan Commercial Co.,* 94 S. W. 527.

7. **A complaint setting forth the particular facts and circumstances under which it is claimed that one person has received and has money he ought not in equity and good conscience to retain, but ought to return, is as much a complaint for**

money had and received as though it were in the form of the common count for money had and received. 41 C. J. 63; *Chung Kee v. Davidson,* 102 Cal. 195.

8. The right of action for the recovery of the fraudulently diverted money was in the corporation. It was property of the corporation, and, as such, it is now vested in the trustee in bankruptcy. *In re Thomas,* 156 Fed. 214.

9. There is likewise vested in the trustee all rights of action on behalf of creditors of the corporation. 7 C. J. 246; *Cottrell v. Albany Card & Paper Mfg. Co.,* 126 N. Y. Supp. 1070.

When the president of the corporation paid out its money for a non-existent tax upon the false return, he violated his trust as an officer of the corporation. The defendant, to whom the money was paid in violation of the trust, became a like trustee, since, regardless of the good faith in which the money may have been received, it was received for no valuable or other consideration. The defendant, having thus received money of the corporation without consideration, is in a position where in equity and in good conscience he ought not to retain the money, but ought to return it to the corporation.

The corporation being now in bankruptcy, all rights of action in the premises, both on its behalf and on behalf of its creditors, are vested in the trustee in bankruptcy, the plaintiff herein.

Under the stipulated and admitted facts, plaintiff should therefore have had judgment against the de-

fendant, as for money had and received, unless the defense interposed by the defendant is sound.

THE DEFENSE.

Th defense was rested upon a limitation upon the jurisdiction of the Court assumed to be imposed by Sec. 606 of the Revenue Act of 1928, the argument being divided into four points, as follows:

1. **That this action by the trustee in bankruptcy is precluded by the agreement as to final determination of tax liability executed by the vice-president of the corporation. The agreement is generally referred to as a "closing agreement."**

2. **That the fraud in this transaction is such as exempts the "closing agreement" from the operation of Sec. 606 of the Revenue Act of 1928.**

3. **That an action upon the ground of fraud will lie only against the person guilty of the fraud.**

4. **That only an innocent person can complain of fraud.**

The claim thus sought to be defeated is not only so inherently just that there ought to be a refund by the government without suit; but, by reason of its nature, since it arises out of fraud, it is exempt from the operation of the Act by the plain language of the Act itself. The closing agreement provided for by the Act is made by the Act final as well as conclusive upon the Courts "except upon a showing of fraud." In

addition to the fact that the Act exempts cases founded upon fraud, the fact is that the Act itself has no bearing upon this case.

In this connection the defendant relied upon the cases of *Bankers Reserve Life Co. v. U. S.,* 42 Fed. (2d) 313, and *Aetna Life Ins. Co. v. Eaton,* 40 Fed. (2d) 965, 43 Fed. (2d) 711. These cases involve a similar statute (Sec. 1106(b) of the Revenue Act of 1926), but they are not determinative of the issue here. In neither of these cases was fraud involved. In each case all the facts were known, both to the taxpayer and the government. In each case the tax return reflected exactly and in full the true income upon which the tax was assessed and paid. By reason of a subsequent decision of the Supreme Court in another case it had developed that certain income reported and assessed should have been exempt, and it was sought to recover the excess thus appearing to have been paid. The closing agreements, executed after the payments, were held to bar recovery. The reason for the bar is clearly stated by the Circuit Court of Appeals, 43 Fed. (2d) at 713, where it is said:

> "No fraud, malfeasance or misrepresentation of fact, affected the assessments there claimed."

Therefore, of course, the statute was a complete bar. Fraud being the foundation of the action here, neither of these decisions can have any bearing upon the issue now before the Court.

It was argued by the defendant that the fraud exempted by the statute from its operation must be

such fraud as pertains to the making of the closing agreement, and not to the causing or making of the original return. This argument involves both an error of law and a misconception of the extent and effect of the fraud in this case. The fraud that brought about the erroneous tax return, that is, the falsification of the corporation's books by the president, was a continuing fraud. It entered as effectually into the making of the closing agreement as it did into the false return. The closing agreement was, therefore, a direct result of the fraud.

But fraud as a cause of the return, as distinguished from the closing agreement, is an entirely sufficient foundation for this action. Recent as is the statute in question, that point has been fully determined, and this too by a case cited by defendant in support of his contention, and evidently not followed by the trial Court. The case is that of *Carter Music Co. v. Bass,* 20 Fed. (2d) 391. In its opinion the Court stated the facts and its conclusions as follows:

> "The case made here is simply this, as established by plaintiff and admitted by defendant: Plaintiff paid defendant, for the year 1920, $4,-950.34 more than was due for that year. This payment was made to defendant **upon his assertion to plaintiff that that amount was due,** and upon his demand for payment, and plaintiff would not have paid it, except for the claim and demand. From this statement it follows, nothing else appearing, that from the standpoint of natural justice and equity defendant has taken and is withholding from plaintiff without right $4,950.34 of plaintiff's money.

Upon what theory, then, does the defendant refuse payment, and does he contest it here? Simply this: That though the defendant recognizes the injustice of the situation, that the United States should keep money which had been wrongfully exacted from plaintiff through him, and has endeavored to assist the taxpayer to obtain a refund, he is prevented from making such refund, and required to defend this suit, by a ruling from Washington that, 'while there is no doubt that the opinion works a hardship on the taxpayer,' they are of the opinion that plaintiff is not entitled to recover because of the fact that, **after plaintiff had, on December 5, 1922, paid** the money for which it sues, it did **on October 6, 1923, execute an agreement in writing,** which agreement they say was executed under the authority of, in accordance with, and has the effect ascribed to it by section 1312 of the act of 1921 (Comp. St. Sec. 6371 4/5gg) and section 1106b of the act of 1926. * * * Plaintiff meets the defense of the agreement with two propositions: (1) That there was no assessment and determination of taxes for the year 1920 made and agreed to as contemplated in the statute. (2) That, if there was such an assessment and agreement made as contemplated by the statute, it cannot constitute a defense to this cause, because, if in fact made, the payment by plaintiff **and the agreement following** were all induced by a misrepresentation of fact, which under the very terms of the statute deprives them of any effect.

Examining these contentions, I think they both must be sustained."

It was argued by the defendant that an action upon the ground of fraud will lie only against the person

guilty of the fraud, that is, where the fraud was participated in by the defendant. This is true as to actions **for damages** upon the ground of fraud. Here we have, not an action for damages, but for money had and received. It is maintainable against the defendant, not on the theory that he was guilty of or in any manner participated in the fraud, but because he is the beneficiary of the fraud. It was he who received the money fraudulently caused to be paid out of the corporation's funds. He is, therefore, chargeable in this action, not as upon a cause of action for damages, but for the money he received. The nature of the action and the basis of defendant's liability are clearly set forth in *Carter Music Co. v. Bass* (supra). The Court there said:

> "This is a suit at law, brought under the authority of and in accordance with the statutes of the United States allowing such suit, and the principles of the common law controlling same, against J. W. Bass, collector of internal revenue, to recover from him personally for sums collected by him and paid to him as taxes in excess of amounts actually due by plaintiff.
>
> That such a suit can be maintained, that it is personal, and that it is controlled by the common-law principles of a suit in assumpsit on the money counts, except as modified by statute, is well established by the authorities. Sage v. United States, 250 U. S. 37, 39 S. Ct. 415, 63 L. Ed. 828; Smietanka v. Indiana Steel Co., 257 U. S. 4, 42 S. Ct. 1, 66 L. Ed. 99; International Paper Co. v. Burrill (D. C.) 260 F. 664; New York Life Ins. Co. v. Anderson, (C. C. A.) 263 F. 527; Holmes, Federal Taxes (6th Ed.) 1547. Of such suits

> Holmes, supra, says: 'Suits against collectors are brought on the theory of money had and received. In such suits the plaintiff may recover only such money as he is in equity entitled to, and as defendant is not entitled to retain.' In the Anderson case, supra, it is said: 'That a taxpayer's suit of this sort is essentially an action of assumpsit for money had and received has been too long settled to admit of doubt.' "

The defendant also argued that only a plaintiff innocent of fraud can complain of the fraud. It was said that the trustee in bankruptcy stands in the shoes of the bankrupt corporation, and has no better right than the bankrupt itself. This argument ignores two facts that defeat it: (1) the bankrupt corporation was not guilty of the fraud, and (2), while the trustee represents in a sense the bankrupt, he is also and primarily the representative of the creditors of the bankrupt, and as such is vested with all their rights. It will be observed that the complaint alleges and the supplemental stipulation admits, "that at the time of the making of said return and said payment said corporation was largely indebted to persons, firms, and corporations who are now creditors of said bankrupt estate." It is on behalf of these existing creditors who were defrauded that the trustee sues here. The argument of the defendant takes cognizance only of the law applicable to the most common action for money had and received arising out of fraudulent transactions, that is, an action by the injured person against the one who defrauded him. In such actions, and the transactions upon which they are founded, but two persons are involved. In the situation here

presented five persons or groups are involved. They are: (1) the president of the corporation, who falsified the books upon which the return was based; (2) the corporation, whose money was wrongfully paid out; (3) the defendant, who received the money without consideration; (4) the existing creditors of the corporation, who were defrauded by the wrongful payment, and who are now creditors of the bankrupt estate; and (5) the plaintiff, who, as trustee, represents not only the corporation, but the defrauded creditors in whose right he sues.

With this distinction in mind, it is clear that it is not the guilty person who brings this action; nor is it brought upon his or its behalf. The guilty person was the president of the corporation. His falsification of the books was not within his authority as president. It was antagonistic to the corporation, and therefore not the act of the corporation. Nor was the tax return, founded as it was upon the falsified books, the free act of the corporation. It is not on behalf of the defrauded corporation or its stockholders that the trustee sues here, but on behalf of the existing and defrauded creditors of the corporation. The defendant is not sought to be held by reason of any participation in the fraud, but because he received the fruits of the fraud, that is, the money paid as a tax when there was in fact no income to be taxed. The injured persons are the creditors, and it is their injury and right that are the foundation of this action.

The injured persons being the creditors, no closing agreement of the corporation could destroy their rights. They have done nothing to waive their right;

nor has their representative, the trustee. A corporation cannot defeat its creditors by fraudulently paying out its funds so as to place them beyond the reach of its creditors. Nor, after such payment, can it waive any right of the creditors by any subsequent agreement with the person to whom the money was paid.

Applying the principles stated in the opening paragraphs of this brief, this is simply a case where, by reason of the fraudulent act of its president, money of the corporation which should belong to creditors of the corporation was paid to the defendant. The defendant received the money without parting with anything of value therefor. The defendant is, therefore, in the position of having received money which in equity and good conscience he ought not to retain, but ought to pay to the creditors of the corporation,—or to the plaintiff, who, as trustee in bankruptcy, represents the creditors in this action. In its last analysis it is a case in which one person has been deprived of money by the fraud of another, and the fruits have gone to a third person. The successors in law of the defrauded persons, that is, the creditors who were such at the time, bring this action through their representative, the trustee, not in the right of the defrauded corporation, but in their own right as creditors existing at the time of the fraudulent payment. The subsequent closing agreement between the corporation and the beneficiary of the fraud cannot waive the rights of these creditors.

It is submitted, therefore, that the defendant is liable as for money had and received, and that his liability is to the creditors, or the trustee who repre-

sents them as plaintiff in this action. The judgment should have been for the plaintiff as for money had and received by the defendant. The judgment rendered for the defendant should be reversed.

Dated, San Francisco,
October 10, 1931.

Respectfully submitted,
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